

**Letter of Findings Number: 02-20110168
Adjusted Gross Income Tax
For Tax Years 2006-08**

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ISSUES

I. Adjusted Gross Income Tax–Business/Non-Business Income.

Authority: The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001); I.R.C. § 338(h)(10); IC § 6-3-2-2; [45 IAC 3.1-1-29](#); [45 IAC 3.1-1-30](#).

Taxpayer protests the reclassification of income from non-business income to business income.

II. Tax Administration–Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation doing business in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had reported business income as non-business income and had therefore under-reported its Indiana adjusted gross income tax ("AGIT") during the audit period of 2006, 2007, and 2008, with additional AGIT due only in 2008. The Department therefore issued proposed assessments for AGIT, interest, and penalty for 2008. Taxpayer protests that the income was non-business and was therefore allocated to another state rather than apportioned to Indiana. Taxpayer therefore protests the imposition of AGIT, interest, and penalty for 2008. An administrative hearing was held and this Letter of Findings results. Further facts will be provided as required.

I. Adjusted Gross Income Tax–Business/Non-Business Income.

DISCUSSION

Taxpayer protests the imposition of AGIT for the tax year 2008. Taxpayer protests that the Department erred in reclassifying income which Taxpayer received from the sale of a subsidiary from non-business income to business income. The result of this reclassification was to increase Taxpayer's apportionable income and thus to increase Indiana AGIT for 2008. Business income is apportioned in Indiana as provided by IC § 6-3-2-2(b). Taxpayer states that the income in question was non-business income and was properly allocated to another state. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

In determining that the gain on sale amount was business income, The Department relied upon [45 IAC 3.1-1-29](#) in determining that the income in question was business income. [45 IAC 3.1-1-29](#) states:

"Business Income" is defined as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business. Nonbusiness income means all income other than business income. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business.

Further guidance in determining business income under Indiana law is found in The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), in which the Indiana Tax Court determined that [IC 6-3-1-20](#) provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

In May, the court looked to [45 IAC 3.1-1-29](#) and 30 for guidance in determining whether income is business or business income under the transactional test. These regulations state, "the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." Id. at 664. [45 IAC 3.1-1-30](#) lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was

not in the business of selling entire divisions. Id. at 664.

Taxpayer states that the sale of its subsidiary does not meet either the transactional test or functional test and that the income from the sale is therefore non-business income. Taxpayer states that the sale of the subsidiary was a "deemed asset sale" under I.R.C. § 338(h)(10) and that several states other than Indiana have court decisions ruling that such sales are non-business income. The Department notes that, since these decisions are from the courts of other states, these decisions are not controlling in Indiana. Therefore, these decisions will not receive any further discussion.

In this case the transaction was the sale of Taxpayer's credit subsidiary. Taxpayer decided that, after thirty years of operating the subsidiary to arrange credit between and for Taxpayer and other related entities, the benefits of operating the subsidiary were no longer adequate to warrant operating the subsidiary. Taxpayer then conducted an I.R.C. § 338(h)(10) "deemed asset" sale. Taxpayer opted to reorganize its business voluntarily by ending its long-standing subsidiary's credit operations. This is the exact opposite of the case in May, in which the taxpayer continued to operate department stores and merely sold one recently-acquired division of such stores after being ordered to do so via a court decision.

Here, Taxpayer opted to abandon the credit subsidiary's business entirely and opted to get into the business of selling all assets of that credit subsidiary. Thus, the relevant transaction to review in this case is not the credit business in which the subsidiary had been engaged but rather the relevant transaction is the liquidation of the subsidiary which Taxpayer chose to make the subsidiary's final business action. Therefore, the nature of Taxpayer's business changed from owning a credit subsidiary to liquidating a subsidiary, which could only happen one time, to raise a substantial amount from property it owned for thirty years and to eliminate the business inefficiencies of operating an under-performing subsidiary. The sale of the subsidiary meets these transactional test factors as provided in May and the gain on the sale amount was income from this business action.

The functional test focuses on the property being disposed of by the taxpayer. May, at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. 664. The court in May defined "integral" as necessary or essential to complete the whole. Id. at 664-5. The court held that May's sale of one of its retailing divisions was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In this case, Taxpayer's sale of an entire subsidiary was necessary and essential to its regular trade or business since the subsidiary was a functioning arm of Taxpayer's operations for thirty years. The subsidiary was formed to facilitate Taxpayer's core operations, was operated to meet the needs of the core operations, and was sold when it no longer met those needs to Taxpayer's satisfaction. Under the definition supplied by the court in May, in this case it was integral to Taxpayer's business to acquire, manage, and then sell the subsidiary. Consequently, under May, the gain on sale amount is business income.

Taxpayer's sale of the subsidiary meets both the transactional test and the functional test as set out in May. The transactional test is met by virtue of the fact that Taxpayer made a voluntary business decision to streamline its overall operations by selling a subsidiary which no longer met its overall needs. The functional test is met by virtue of the integral nature of the subsidiary's operations in Taxpayer's overall business strategy. The income from Taxpayer's sale of the subsidiary was therefore business income subject to apportionment in Indiana. Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Tax Administration—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated

as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

[45 IAC 15-11-2](#)(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under [45 IAC 15-11-2](#)(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer was denied on its protest in Issue I it has affirmatively established that the deficiency was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2](#)(c). The negligence penalty will be waived.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest is denied on Issue I regarding imposition of adjusted gross income tax, as described in Issue I. Taxpayer's protest is sustained on Issue II regarding imposition of negligence penalty.

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